Connect PUBLIC AFFAIRS

BUDGET 2007 BRIEFING

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1. THE STATE OF THE ECONOMY

The Chancellor will give his eleventh, and almost certain to be his last, Budget at 12.30pm on Wednesday 21 March.

It is likely that the Chancellor will use the Budget to set the framework for a future Brown administration. The Chancellor will also see it as an important opportunity to reiterate how well he believes he has handled the economy while improving public services, particularly after a YouGov poll on 22 February found that 30 per cent of voters asked, thought that the Conservatives were likely to run the economy well, compared to 27 per cent for Labour.

The "state of the economy" Budget report will cover four areas: growth; trade deficits; the 'Golden Rule' of having a balanced Budget at the end of the economic cycle; and the current position on the Comprehensive Spending Review.

Growth

The Chancellor is unlikely to alter his economic growth forecast of between 2.75% and 3.25% for this year and 2.5% to 3% for the next. However, there has been speculation that because the economy has remained strong since the pre-Budget report in December, there is an outside chance he could upgrade them.

In particular the Chancellor will be heartened by Office for National Statistics' figures showing that the economy grew at its fastest pace in more than two years in the final quarter of 2006. The ONS second estimate for economic growth showed GDP up by 0.8% in the last three months of 2006, the strongest rate since mid 2004, taking the annual rate to an unrevised 3%.

Trade deficits

However, there are signs that economic growth may be at its peak. One such sign is the trade deficit on goods and services, which rose by a quarter to £56 billion last year, with the deficits reaching 2% of national income for five out of the last ten years.

A further sign is the growing deficit of spending over income, during last year's Budget the Chancellor predicted that there would be a surplus in 2007-08, however in the recent Pre-Budget Report the surplus was postponed until 2008-09.

The Golden Rule

The Chancellor's expectation of meeting his golden rule (that the Budget will balance at the end of the economic cycle) will depend on the Treasury's stated timing of the economic cycle over which it is judged. This practice has been controversial in recent years, and could cause big problems for whoever succeeds the Chancellor in the future if the economy was to take a downturn.

Analysts have stated that without the extra two years that the Chancellor added to the beginning of the cycle in 2005, Treasury forecasts would now show him breaking the rule by £5½ billion. Using a statistical filter, rather than estimates by the Chancellor's officials, Morgan Stanley's modeling suggests that the current cycle may have started in 2003-04 and run to around 2009-10. Over this period Treasury forecasts imply that the golden rule would be broken by £57 billion; the Institute of Fiscal Studies would expect it to be broken by £66 billion.

Add this to a Comprehensive Spending Review expected later in the year, it is unlikely that the Chancellor will give away any significant levels of unexpected cash. In fact the Institute of Fiscal Studies has recently stated that:

'*Looking forward over the period in which Mr Brown hopes to fight his first general election as Prime Minister, the Chancellor is aiming to cut his borrowing by a further £20 billion over the next five years to stay on course to meet his self-imposed fiscal rules. To that end, he is projecting a further £10 billion increase in the tax burden and has pencilled in a £10 billion cut in public spending.*'

Comprehensive Spending Review (CSR)

The main focus of the Budget is likely to be on the implications it has for the CSR later this year. It is thought that Brown will use this year's Budget to announce the overall spending plan to cover the three review years, 2007-08, 2008-09 and 2009-10.

It will be his successor, however, who will announce how the cash allocations are to be divided up. Most forecasters expect the Budget and the CSR to spell out how tight public spending under Brown as Prime Minister will be.

2. BUDGET PREDICTIONS

Public Spending

Public spending could be the Chancellor's biggest headache. It is widely anticipated that he will say that public spending over the next three years will grow by less than the 2% annual increases that government departments had previously expected.

Senior Treasury officials are reported to have had '*hard-nosed discussions*' with spending departments, meaning the Chancellor would be able to present figures showing a bigger tightening than envisaged three months ago in his Pre-Budget Report.

In December, the Chancellor said public spending would grow by 2% above inflation each year, against recent increases of between 4% and 5%. The new spending 'envelope' for 2008 to 2011, to be fleshed out in the CSR, is now predicted to be about 1.75%.

Experts say the squeeze will make it hard for the Government to meet its commitments.

Robert Chote, Director of the independent Institute for Fiscal Studies has said:

'*Our view was that even if you were very tough on everything else, with 2% it was hard to see how the government could meet its targets.*

'This leaves you with a trade-off between health and education. One is going to be squeezed.'

The clampdown will mean that public spending in 2011 could be £12-13 billion lower than if it were to rise in line with the economy.

The Chancellor will achieve the slower growth by hitting some departments hard, John Reid, the Home Secretary, has already agreed that his department's Budget will be frozen in real terms.

The tightening could also be felt by public sector workers. Since 1998 the Government has increased the number of public employees by nearly 700,000 to 5.85m. The trend could now likely go into reverse.

Earlier this month the Chancellor announced a below-inflation 1.9% pay rise for public sector employees, with GPs' pay frozen. This pay squeeze is likely to continue in the coming years.

However, Richard Chote has also argued that the Chancellor's tactic could make life tougher for the Conservative Party:

'*It makes it more difficult for the Conservatives to say they can squeeze more juice out of this orange*.'

But he added the clampdown may backfire, as voters could blame Brown for mismanaging public finances.

Environment

Environmental issues appear to have taken and maintained centre stage recently with the publicity generated by the online road pricing petition serving as a particularly emotive issue.

It is unlikely that road pricing will feature in the Budget, although the Chancellor is likely to take the opportunity to highlight the Government's commitment to reducing emissions. Indeed, with the recent post-Kyoto announcements, it would seem that further environmentally-driven tax changes can be expected. The Chancellor will use his last Budget speech to portray himself as a statesman aware of the environmental challenges ahead, and head off any potential leadership challenge from the Environment Secretary, David Miliband.

Further measures could be increases in fuel duty or Vehicle Excise Duty. Other possible measures include a further rise in Air Passenger Duty, although this is probably unlikely so soon after the last one, and changes to the Climate Change Levy and Landfill Tax. The Chancellor may also announce further anti-avoidance measures.

On 13 March the Government launched the Climate Change Bill. It has been reported that Gordon Brown clashed with Miliband and effectively watered down what is considered to be a landmark bill on climate change.

The Chancellor, who pre-empted the bill with his own major speech on green issues on 12 March, is understood to have objected to attempts to earmark revenues raised through carbon taxes for purely green causes.

A close ally of the Environment Secretary, was reported to have said '*David is having quite a dispute with the Treasury about all of this and Gordon is being very difficult about it…Any mention of hypothecation* [earmarking taxes or revenue for a particular cause] *and you are finished as far as the Treasury is concerned.*'

Lyons Review

The long awaited Lyons Report on local government finance is due to be published by Sir Michael Lyons in advance of the Budget. The Chancellor is likely to comment on Lyons' key recommendations, giving an insight into how these will be implemented. In particular, it is expected that Lyons will recommend significant reforms to the system of local government finance in the long term, and some changes to the current council tax system in the short term. These will include an increase in the number and range of council tax bands, which according to some reports could lead to a doubling of council tax on homes worth over £1 million. In addition, Lyons is expected to recommend some new tax raising powers for local authorities, such as for rubbish disposal, or 'green' taxes.

Pensions

The Government is this year expected to make major announcements on the pensions system. Recent Budgets have usually had some impact on private pensions. It is expected that there will be further announcements regarding death benefits under pensions. Changes may simply follow the announcements in the Pre-Budget Report, but consultation may be successful in creating a level playing field between Unsecured Income and Alternatively Secured Pensions (ASPs).

With the proposed heavier tax burden on ASPs, there is expected to be an increase in the number of Family Charitable Trusts being set up. Consequently, the Chancellor may move to reduce the tax benefits for transfers out of pensions into Family Charitable Trusts.

In the detail of the Budget Report, it is expected that the Treasury will make an announcement over the review of permitted investments for pensions. This could include an attack on AIM shares being transferred into pensions if the inheritance tax breaks for these shares disappear.

It is likely that the Chancellor will make some clarification on life assurance associated with pensions as it is difficult to fathom that it was his intention that no income tax relief was available for premiums paid in respect of such policies.

It has also been predicted that the main areas which might be attacked by the Chancellor will be higher rate relief on pension contributions and tax free lump sum payments from pensions, with a further examination of the taxation of insurance funds held offshore for UK residents also expected.

Corporation Tax Rates

The Chancellor has come under some criticism for the complexity of the business tax system, leading to a perceived drop in competitiveness of the City

Paul Davies, Head of Tax at Ernst and Young:

'Although the City is working hard to maintain its status as an attractive business destination, the UK is losing ground because of the growing complexity and uncertainty of the tax system. In fact, as the rate of UK corporation tax slips further and further

down the OECD table, there has been a notable lack of targeted Government action to tackle the problem.'

With continuing calls from both opposition parties and organisations such as the CBI, a move to a single rate of corporation tax could be attractive to the Chancellor. HMRC is still seeking a way to reduce the usefulness of managed service companies to get round IR35 and family companies which take advantage of the starting rate of 19% to reduce their income tax and NIC burden by converting profits to dividends paid to spouses.

Corporation tax rate bands have not been updated for over a decade. Therefore the Chancellor may decide that the time is right for a more radical solution: a single rate of corporation tax, it has been argued, would not only address the issue of international competitiveness for large corporate firms, but would also reduce the attractiveness of companies for the self-employed. Therefore it would not be surprising to see the announcement of a single rate of corporation tax, possibly to be phased in by gradual reductions in the main rate and increases in relief for smaller companies until they converge at 25%.

Corporate Finance/Private Equity

Much attention has been given to the issue of private equity and corporate finance. The Chancellor has come under increasing pressure from a GMB-led campaign and from his own backbenches to scrap tax relief on interest. The sector will therefore be watching nervously to see if the Chancellor reacts in a way which threatens the growth of what some believe to be one of the UK's biggest business success stories. It has been reported that as well as the billions of pounds of income it generates for the City, it helps fund over 1,500 UK businesses a year.

However, as the industry has grown, the targets have become ever bigger and have now reached into the heart of British public life, most recently with the rumours of a possible bid for the Sainsbury's supermarket chain.

Nevertheless, it is highly unlikely that the Chancellor will move to further limit the tax relief on debt interest, particularly after the Economic Secretary and close Brown ally Ed Balls, in a recent speech to the London Business School, gave the Treasury's qualified support to private equity.

Moves could also potentially cause serious disruption in the capital structure of UK businesses, both private and public. Limiting changes to the private equity industry alone would cause an uneven playing field and therefore seems unlikely.

Further to the tightening of tax relief on shareholder debt, announced two years ago and coming into full effect this April, it is doubtful we will see further changes that might affect the UK private equity industry, or merger and acquisitions activity more generally.

Charities and Education

The concern about perceived abuse of charity tax exemptions and relief that gave rise to anti-avoidance measures last year is fresh in the minds of Treasury officials, and further changes can be expected.

This time, it may be that the measures for change will be directed more at the sector's increasingly innovative tendency to stretch the boundaries of tax exemption rather than the more aggressive abuses targeted in 2006.

This may result in a curtailment of Gift Aid on donations by individuals; it is known, for instance, that the new visitor admissions scheme, started in April 2006, is not working as well as intended and there are other areas where officials believe that Gift Aid is encouraging tax relief rather than promoting charitable donations. This could result in changes to the donor benefit legislation. High profile cases involving perceived abuse of tax relief on share giving may also lead to amendment to that particular piece of legislation.

Finally, there are known to be discussions in one area of the sector, social housing, where shared ownership sales seem to be causing difficulties with the primary purpose trading exemption and there may well be some clarification on this in the Chancellor's Report.

Planning Gain Supplement

Further consultations on the Planning Gain Supplement (PGS) were announced in December 2006 following the original proposal in the 2005 Pre-Budget Report.

Introduction of this measure has now been put back to 2009 at the earliest. With the deadline for consultation responses passing as recently as February this year, it seems unlikely that specific proposals will be introduced by the Chancellor in the Budget. More likely is that he will refer to further consultation, particularly connected to the passage through Parliament of the Planning Gain Supplement (Preparations) Bill, a preparatory Bill for any potential instigation of a Planning Gain Supplement.

Gambling

With the increased focus on the gambling and gaming industry after the announcement of the new Supercasino in Manchester, the Chancellor is expected to unveil plans to encourage online gambling firms to move to the UK to be regulated and licenced in the UK. There is a widely held view that the Treasury would like to boost its income through the taxation of such firms, who are currently based in Gibraltar.

From September, the companies will be allowed for the first time to relocate to the UK and obtain a licence under the Gambling Act. However, the companies have said they would not relocate to the UK if they had to pay a tax on gross wins as High Street casinos do: currently, casinos pay tax of up to 40%, depending on their size.

In what is expected to be a surprise move, the Chancellor will use the Budget to announce that in return for a small amount of tax, reportedly as low as 2 or 3%, companies could obtain a UK licence and still remain based overseas. The new tax would be called Remote Gaming Duty.

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